DNR Briefing Material - Volume 4

November 10, 2004

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Introduction

This volume of the Briefing Materials (Volume 4) provides responses to questions and requests from the trust beneficiaries.

The questions and requests are grouped into three major categories:

- *Questions about Comparability*
- *Questions about History and Current Status*
- *Questions about the Future and Projections*

A number of the questions were very similar and have been consolidated. Other questions were re-stated to clarify the question to facilitate a more precise answer. Within these changes, we have tried to preserve the essential nature of the original questions. (For reference, the original questions submitted to the department are included as an appendix.)

Many of the questions were submitted early in the Independent Review Committee's process, and were then essentially answered in material prepared in volumes 1-3 of *Briefing Material for the Independent Review Committee.* The answers in this volume may refer to those earlier volumes of "Briefing Material."

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Questions about comparability

1. **How do other state land offices manage trust lands for their beneficiaries without a management fee?**
   How does the 25 percent management fund share compare with how forestlands are managed elsewhere?
   How does DNR's cost structure compare to that of outside land managers?

Idaho

Nine beneficiaries — 2,464,000 total acres, including 1,020,000 acres of forestlands.

Starting with fiscal year 2001, Idaho changed its accounting system for trust land management expenses. Prior to that year, the Department of Lands was funded from a portion of dedicated "improvement" funds and state general funds. Since FY2001, the management of endowment lands has been 100 percent self-supporting. The Department of Lands distributes 100 percent of all endowment land revenues to the Endowment Fund Investment Board, which in turn reimburses the department for its actual expenses on a quarterly basis.

The ratio of expenses to revenues has ranged from 16.8 percent in FY2001 to 26.4 percent in FY03. The Department of Lands maintains a "float" of $1-2 million per year to cover operating expenses as they occur. Administrative and overhead costs are allocated between the endowment land management activities and other department activities (fire fighting, forest practices, etc.), which are funded by dedicated funds and the state general fund. These dedicated funds and state general fund are not available for managing the endowment lands. The Department of Lands tracks management costs by asset class (forest, agriculture, commercial) and by endowment ownership.

Oregon

Common School trust — 763,000 acres, including 133,000 acres of forestlands
Board of Forestry — 780,000 acres of forestlands

Although all non-forested trust lands are managed by the State Lands Department, state trust forests are managed under an agreement between the Department of State Lands (DSL) and Department of Forestry (ODF). The Common School trust forestlands are intermingled with the Board of Forestry lands managed by ODF in five state forests, located mostly on the west side of the state, and with the vast majority of common school acres in one state forest.

For the Common School trust lands, the ODF transfers 100 percent of revenues earned as they are received and invoices DSL for costs of management. Administrative and overhead costs are prorated based on acres for site-specific costs, or on statewide acres for agency-wide activities. The six-year average (1998 through 2003) for reimbursable costs between ODF and DSL was 25.65 percent, and ranged from 17.13 percent in fiscal

year 2000 to 51.73 percent in fiscal year 2003. Preliminary numbers for FY2004 reimbursable costs are 32.31 percent. The two departments are currently negotiating a target funding level for fiscal year 2005 and beyond for reimbursable costs in managing the Common School lands. The Oregon Legislature has directed DSL to develop a system to separate expenses by revenue stream (cost accounting by asset class) starting with their next biennium.

For the Board of Forestry (1 beneficiary/15 counties) lands, during the last five years (fiscal years 1999 through 2003), the amount of revenue withheld to cover the costs of management has ranged from 22.24 percent to 29.36 percent.

Montana

Ten trusts — 5,163,000 acres, including 727,000 acres of forestland, with the Common School trust having 4,633,000 acres, or 90 percent of total trust acres

The Trust Land Management Division of the Montana Department of Natural Resources and Conservation (DNRC) manages these lands. The division is funded by a combination of state general funds and dedicated revenues from trust management activities. The funding formulas (revenue distribution and expenditures) are different for the common school trust lands and all other trust lands managed by DNRC. Montana's funding scheme is complex and utilizes a combination of dedicated fee-based revenues, retention of a small percentage of trust activity revenues (generally 5 percent or less), and state general fund monies to fund the Trust Land Management Division.

On Common School lands and from distributable receipt activities, a small percentage is allocated to the Resource Development Account and Timber Sale Account. No money is distributed to the timber sale account from non-common school trust lands. The remainder of the distributable receipt revenue is distributed to the Guarantee Account for use by the public schools. Fees assessed on individual timber sales are distributed to the Forest Improvement Account. Public access and use activities are funded by fees paid for a general recreational use license to access state trust lands. In 1999, the Montana Legislature created the Trust Administration Account, which is funded from a small percentage of revenues from land sales, mineral royalties, rights-of-ways and other activities from which the majority of revenue is distributed to the non-distributable permanent funds. The 1999 Legislature required the Board of Land Commissioners, which oversees the Trust Land Management Division, to provide annual reports regarding the average return of revenue on asset value to trust beneficiaries of forested lands, by land office location.

Grays Harbor County , Washington

The County manages 37,436 acres of formally tax delinquent lands, 35,644 acres of which are forested. Total revenues for calendar year 2003 were $608,385, with $448,803 from timber sales. Timber sales revenue is distributed 78 percent to the tax districts based on the current levy rates (similar to forest board transfer lands in other counties). The remainder (22 percent) is retained to fund the operations of the Department of Forestry. The County has deducted up to 25 percent in past years from timber sales to fund its

management activities. Other revenue sources (road use permits, facility rentals, special forest products permits, tideland leases) are distributed based on other funding formulas. The amount retained (22 percent) to fund department operations does not include costs for administrative or overhead services provided by the county (payroll, revenue receipts, legal services, etc.) with the minor exception of janitorial services on the department's own building, equipment/vehicle rentals from the county motor pool, and GIS/computer services.

2. Will the private sector be surveyed to obtain management cost data and, where applicable, be compared to DNR management costs to ascertain opportunities for further management efficiencies and savings?

Yes. Please see Briefing Material, Volume 2, Section 4. DNR has evaluated limited information from PricewaterhouseCoopers LLP and plans to participate in a fuller benchmark study early next calendar year. Similarly, there is a planned benchmark study that will start later this year, to be conducted by Atterbury Consultants, Inc.; similarly, DNR plans to participate in the Atterbury benchmark study.

As noted in Section 4.2 of Volume 2, DNR did talk with a larger private forest landowner in western Washington. Their percent of gross revenue used in land management ranged from a high of nearly forty percent down to just under thirty percent.

3. How do the current land treatments and "on the ground" management practices compare to the most economically efficient land treatments? Are similar treatments and practices used by outside land managers? If there is a difference, what is the impact on revenue, related RMCA revenue and associated management costs? What economic analyses indicate how the trusts were impacted (either positively or negatively) by the recent sustainable harvest calculation?

Management practices are largely set by objectives. Other land managers may have similar or dissimilar objectives. Please see Briefing Material, Volume 2, Section 4.1.

The investment horizons and risk tolerance are significant factors that control on-the-ground practices. As a trust manager, DNR's objectives are tempered by the common law duties of a trustee and express laws that either created or govern the trust. Similarly, the existence of a Habitat Conservation Plan provides benefits and responsibilities that change our practices, making direct comparisons with other managers difficult.

Different alternatives were analyzed in the *Alternatives for Sustainable Forest Management of State Trust Lands in Western Washington Environmental Impact Statement.* The Final EIS document may be found at www.dnr.wa.gov.sepa. Some alternatives produced increased revenue in the near-term but had other consequences that were seen as unacceptable by the Board. These consequences included substantial inter-decadal variability in revenue levels or not achieving the desired mix of stand structures.

Questions about history and current status

4. What does status quo look like?
Where is the 25 percent being spent today?

DNR has substantially reduced expenditures to reflect the realities of lowered revenues due to historically low timber prices. The Resource Management Cost Account expenditures are the lowest since 1970, when expressed in real 2003 dollars. Nevertheless, the actual expenditure rates are presently close to 30 percent. The net result is that we continue to spend and therefore draw down the fund balance. This answer assumes that the underlying question is about how the DNR is spending the management funds today. Briefing Material, Volume 3, directly answers the question in some detail (see pages 9-12).

Management of these multi-billion dollar trust lands requires investments. Investment money comes from the Resource Management Cost Account and Forest Development Account—the "management funds". The majority of the trust land management expenditures are for personnel—the DNR employees that provide the scientific, professional, managerial and administrative resources to manage 2.9 million acres of trust lands spread across the nearly 43 million acres of the state. Other costs are for goods and services; interagency payments for building rent, audit services and Attorney General legal help; and payment for fire protection services, like any other forest land owner.

See also answer to question 16.

5. Community College Trust – What new lands have been purchased? How was the money spent? Where did it go? What happened to the management fund?

There are four parcels of lands which make up the current Community College Forest Reserve Trust. The first two parcels were acquired in June 1991, the third was acquired in February 2000 and the fourth parcel in August 2003. The following table summarizes the transactions to acquire these lands.

Parcel Name	Acres	County	Land Value	Timber Value	Total Value
Forest Glade	2,741	Snohomish	$4,985,860	$261,140	$5,250,000
TAT	482	Snohomish	767,000	433,000	1,200,000
Phillips	26	King	200,000	0	200,000
Big Lake	120	Skagit	110,000	83,000	193,000
TOTAL	**3,369**		**$6,062,860**	**$780,140**	**$6,843,000**

Since fiscal year 1997 there has been $724,096 of revenue produced from these lands, with 75 percent being distributed to the Community and Technical College Forest Reserve Account and 25 percent to the Forest Development Account, per RCW 79.02.420 (5).

6. What has the gross trust revenue amount been each year since 1971 adjusted to current dollars using a common state inflation adjuster? What have been the expenses in a similar fashion? What is the percent of expenditures by general object of expenditure historically (e.g., salaries & benefits, contractual services, etc.)? This object of expenditure information will provide a glimpse regarding how the allocation of resources might have changed over time. What are the total FTE supporting the Trust over time, and what is the average salary (not adjusted for inflation) of that FTE?

Part 1

What has the gross trust revenue amount been each year since 1971 adjusted to current dollars using a common state inflation adjuster?

Real (adjusted for inflation) gross trust revenues from granted and state forest lands managed by the department since 1965 are shown in Figure 1.

Figure 1 **Real Revenues from Trust Lands Managed by The Department of Natural Resources In million of Real (FY 2003) Dollars**

Biennium	Timber	Leases	Trust Land Transfer (TLT)	Other	Total
1965-67	$ 169.2	$ 15.1	$ -	$ 0.9	$ 185.2
1967-69	$ 212.7	$ 17.4	$ -	$ 1.8	$ 231.9
1969-71	$ 274.0	$ 20.1	$ -	$ 8.2	$ 302.4
1971-73	$ 470.8	$ 23.8	$ -	$ 18.6	$ 513.2
1973-75	$ 395.9	$ 24.7	$ -	$ 26.5	$ 447.1
1975-77	$ 585.3	$ 25.2	$ -	$ 30.2	$ 640.7
1977-79	$ 652.2	$ 20.3	$ -	$ 27.0	$ 699.6
1979-81	$ 545.5	$ 25.2	$ -	$ 49.5	$ 620.2
1981-83	$ 462.7	$ 30.3	$ -	$ 46.2	$ 539.2
1983-85	$ 375.4	$ 24.8	$ -	$ 29.2	$ 429.4
1985-87	$ 391.7	$ 21.5	$ -	$ 36.8	$ 450.0
1987-89	$ 561.9	$ 26.6	$ -	$ 19.6	$ 608.1
1989-91	$ 610.0	$ 26.3	$ 191.7	$ 22.8	$ 850.8
1991-93	$ 428.5	$ 29.6	$ 59.6	$ 11.7	$ 529.4
1993-95	$ 372.9	$ 31.6	$ 45.1	$ 7.1	$ 456.7
1995-97	$ 671.8	$ 38.1	$ -	$ 7.5	$ 717.5
1997-99	$ 517.0	$ 39.5	$ 24.2	$ 13.2	$ 593.8
1999-01	$ 401.4	$ 40.7	$ 59.3	$ 4.5	$ 505.9
2001-03	$ 290.9	$ 41.3	$ 34.2	$ 5.4	$ 371.8
Total	$ 8,389.8	$ 522.4	$ 414.0	$ 366.7	$ 9,692.9

The US Consumer Price Index, for All Urban consumers (CPI-U) was used to adjust for inflation. For the period shown, the department generated $9.7 billion dollars. Of this $8.4 billion was from timber sales, $0.5 billion came from leases, $0.4 from Trust Land Transfer, and $0.4 from "Other" Sources.[1] See Briefing Material, Volume 1, page 24 for more detail on historical revenues.

Part 2

What have been the expenses in a similar fashion?

Figure 2 shows real expenditures from management funds for the same time period.

Figure 2 **Real Management Fund Costs**
RMCA & FDA
In Millions of Real (FY 2003) Dollars

Biennium	Program	Administration and Agency Support	Capital	Total
1965-67				$ 34.7
1967-69				$ 55.7
1969-71				$ 67.0
1971-73				$ 84.6
1973-75				$ 106.1
1975-77				$ 128.2
1977-79				$ 125.5
1979-81				$ 123.3
1981-83				$ 122.2
1983-85				$ 101.7
1985-87				$ 104.2
1987-89	$ 87.1	$ 20.7	$ 4.3	$ 112.1
1989-91	$ 94.4	$ 20.6	$ 5.9	$ 120.9
1991-93	$ 94.6	$ 20.7	$ 4.1	$ 119.4
1993-95	$ 99.3	$ 20.7	$ 3.5	$ 123.5
1995-97	$ 100.8	$ 26.0	$ 6.2	$ 133.0
1997-99	$ 88.8	$ 31.2	$ 5.8	$ 125.8
1999-01	$ 88.0	$ 32.2	$ 4.4	$ 124.6
2001-03	$ 68.0	$ 20.5	$ 8.7	$ 97.2
2001-05	$ -	$ -	$ -	$ 2,009.4

[1] "Other" Sources include timber default payments and other timber related sources ($123 million), land sales ($54 million) and interest on contracts and fund balances ($189 million).

During the past three biennia, DNR has reduced real management fund costs by $36 million (27 percent, from $133 million in 1995-97 to $97.2 million in 2001-03. Real management costs in the 2001-03 biennium are the lowest they have been since 1971-73. From 1987-89 through 2001-03 administration and agency support averaged 20 percent; capital, 4 percent; and program costs, 75 percent. In 2001-03, expenditures for Administration & Agency Support were less than two thirds what they were in 1999-00. These data were taken from the department's annual reports and adjusted for inflation to FY 2003 purchasing power using the CPI-U.

Part 3

What is the percent of expenditures by general object of expenditure historically (e.g., salaries & benefits, contractual services, etc.). This object of expenditure information will provide a glimpse regarding how the allocation of resources might have changed over time. What are the total FTE supporting the Trust over time and what is the average salary (not adjusted for inflation) of that FTE?

Historical objects of expenditure: See Figures 3 and 4, which follow.

Total FTE supporting Trust Land Management: DNR does not have readily historic data due to organizational shifts that have changed labels.

Average Salary: The DNR average salary in tFY2004 was $41,700.

Figure 3. Comparison of Selected Program Expenditures by Management Fund and Object of Expenditure from the 2001-03 Biennium

Program Activity	Forest Development Account FDA - 014	% of Program Activity	Resource Management Cost Account RMCA - 041	% of Program Activity	Ag. College Trust Mgmt. Account ACTMA - 830	% of Program Activity	Totals by Fund
Timber Sales	11,072,284	45%	13,201,793	54%	309,131	1%	24,583,208
Agriculture	19,290	1%	2,683,886	97%	58,012	2%	2,761,188
Leasing and Rights-of-Way	1,340,592	27%	3,569,057	71%	98,238	2%	5,007,887
Silviculture, Nursery and Camps	7,855,698	52%	7,083,130	47%	115,159	1%	15,053,987
Science and HCP	2,069,566	39%	3,141,886	59%	138,807	3%	5,350,259
Data Stewardship	1,565,735	38%	2,427,972	59%	102,964	3%	4,096,671
Roads	2,160,897	100%	5,025	0%	0	0%	2,165,922
Asset Planning & Transactions	861,578	30%	1,936,217	68%	63,941	2%	2,861,736
Survey, Resource Mapping & GIS	2,469,065	31%	5,422,562	67%	155,506	2%	8,047,133
State Lands & Regions Operations	2,664,700	41%	3,787,704	58%	63,657	1%	6,516,061
Law Enforcement	328,806	36%	566,593	62%	15,859	2%	911,258
Information Technology Support	579,082	39%	900,888	60%	17,606	1%	1,497,576
Total	32,987,293	42%	44,726,713	57%	1,138,880	1%	78,852,886

NOTE: This table only shows the funding for the three trust land funds. Several of the program activities listed above receive monies from other funding sources (GF-S, federal grants, etc.), which are not shown in this table. This table also does not show all program activities which spend from the three funds (i.e., primarily administrative programs).

Figure 4 Comparison of Selected Program Expenditures by Management Fund and Object of Expenditure from the 2001-03 Biennium

Program Activity	Salaries and Benefits (obj. A, B)	% of Program Activity	Goods and Services, Travel (obj. E, G)	% of Program Activity	all other expenditure objects	% of Program Activity	Totals by Objects	% of Grand Total
Timber Sales	20,285,586	83%	4,269,745	17%	27,877	0%	24,583,209	31.2%
Agriculture	2,204,518	80%	534,988	19%	21,682	1%	2,761,189	3.5%
Leasing and Rights-of-Way	3,057,142	61%	1,902,486	38%	48,259	1%	5,007,888	6.4%
Silviculture, Nursery and Camps	7,051,005	47%	7,651,628	51%	351,354	2%	15,053,988	19.1%
Science and HCP	3,501,502	65%	593,591	11%	1,255,166	23%	5,350,260	6.8%
Data Stewardship	2,130,766	52%	1,332,362	33%	633,543	15%	4,096,672	5.2%
Roads	931,179	43%	1,190,984	55%	43,759	2%	2,165,923	2.7%
Asset Planning & Transactions	2,108,020	74%	235,677	8%	518,039	18%	2,861,737	3.6%
Survey, Resource Mapping & GIS	5,136,235	64%	2,143,900	27%	766,998	10%	8,047,134	10.2%
State Lands & Regions Operations	4,659,122	72%	1,842,584	28%	14,355	0%	6,516,062	8.3%
Law Enforcement	610,649	67%	256,675	28%	43,934	5%	911,259	1.2%
Information Technology Support	555,684	37%	604,180	40%	337,723	23%	1,497,588	1.9%
Total	52,231,408	66%	22,558,800	29%	4,062,689	5%	78,852,908	100.0%

NOTE: This table only shows the funding for the three trust land funds. Several of the program activities listed above Receive monies from other funding sources (GF-S, federal grants, etc.), which are not shown in this table. This table also does not show all program activities which spend from the three funds (i.e., primarily administrative programs).

7. The summary notes "timber prices have remained low in recent years and re projected to continue at lower than historical levels." Please provide a history and projection of those "timber prices" (actual and adjusted for inflation) historically and on a pro forma basis. We will want to compare the pro forma forecast of timber prices against our forecasted revenue as shown on the Excel spreadsheet entitled Revenue by Fund V14 w_o TLT.xls 8/17/2004.

Real Removal Value ($/mbf) was presented in Graph 4.3 in Briefing Material, Volume 1, page 35. (This graph is reproduced in the answer to question 21 as Figure 8.) Both the actual and projected (pro forma forecast) timber prices for Granted and Forest Board lands are shown in Figure 5.

Figure 5

Removal Price ($/mbf)

		Grants		State Forest		Total	
	Biennium	Nominal Removal Price $/mbf	Real Removal Price 2003 $/mbf	Nominal Removal Price $/mbf	Removal Price 2003 $/mbf	Nominal Removal Price $/mbf	Removal Price 2003 $/mbf
Actual	1965-67					$ 29	$ 162
	1967-69					$ 35	$ 177
	1969-71					$ 50	$ 233
	1971-73					$ 59	$ 253
	1973-75					$ 96	$ 341
	1975-77					$ 142	$ 436
	1977-79	$ 162	$ 426	$ 128	$ 338	$ 155	$ 409
	1979-81	$ 205	$ 443	$ 165	$ 353	$ 198	$ 426
	1981-83	$ 210	$ 393	$ 172	$ 321	$ 201	$ 376
	1983-85	$ 152	$ 265	$ 124	$ 215	$ 144	$ 250
	1985-87	$ 132	$ 218	$ 105	$ 172	$ 124	$ 205
	1987-89	$ 239	$ 360	$ 188	$ 285	$ 221	$ 334
	1989-91	$ 336	$ 466	$ 261	$ 360	$ 310	$ 430
	1991-93	$ 324	$ 419	$ 310	$ 400	$ 319	$ 412
	1993-95	$ 437	$ 533	$ 447	$ 545	$ 441	$ 538
	1995-97	$ 454	$ 526	$ 517	$ 599	$ 483	$ 559
	1997-99	$ 368	$ 410	$ 438	$ 488	$ 400	$ 446
	1999-01	$ 331	$ 348	$ 369	$ 388	$ 348	$ 366
	2001-03	$ 282	$ 285	$ 317	$ 320	$ 299	$ 302
Projected	2003-05	$ 269	$ 257	$ 299	$ 286	$ 280	$ 268
	2005-07	$ 269	$ 234	$ 300	$ 260	$ 281	$ 244
	2007-09	$ 289	$ 239	$ 321	$ 266	$ 301	$ 249
	2009-11	$ 293	$ 235	$ 326	$ 261	$ 305	$ 245
	2011-13	$ 299	$ 226	$ 333	$ 251	$ 312	$ 235
	2013-15	$ 321	$ 228	$ 357	$ 254	$ 334	$ 238

The Excel spreadsheet entitled Revenue by Fund V14 w_o TLT.xls 8/17/2004 was prepared by the department as a part of the sustainable harvest evaluation and used different assumptions than those used in the analysis prepared for the Independent Review Committee. The assumption used in the sustainable harvest analysis and that underlies the Excel spreadsheet is constant real timber prices over the 120-year projection period. The average price for Western Washington during the first decade was $280/mbf. The Excel spreadsheet included Eastern Washington (price in eastern Washington are about 80 percent less than those in western Washington) and non-timber revenues, as did the analysis done for the IRC. In the spreadsheet, average projected net revenue for the "Implement" Alternative were $150.7 million. The projection done for the IRC and shown on page 17 of Volume 3 shows average biennial revenues of $280.2 million or $140.1 million per Year or 7 percent less. These estimates were arrived at independently

and the major difference is due primarily to the lower real prices used in the IRC projection.

For more information on the real prices used in the IRC projections see Briefing Material, Volume 1, page 35.

8. What are the efficiency measures initiated over the last three years, and how much real savings did they generate?
What have been the contributors to increased costs over the past three years and how did those contributors help with the effectiveness of the management of the Trust?

The department has been continually implementing efficiency measures in recent years as falling timber prices have reduced revenue into the management funds, necessitating staff layoffs. It has not been possible to precisely measure savings in all cases. However, examples of efficiency efforts since 2001 include the following:

- Timber sale program expenditures have been reduced by 41 percent while increasing revenue by $15 million.
- Leasing program expenditures have been reduced by 13 percent while increasing revenue 19 percent.
- Two operating regions were combined with savings expected to be near $1 million per year beginning in July 2005.
- A regional office has been co-located with a US Forest Service office, bringing in tenant revenue.
- DNR programs have made much greater use of the agency internet website to interact with the public and customers, saving both employees and the public hundreds of hours previously spent processing paper and phone requests.
- DNR's photo and map sales function has been merged with a similar function at the State Department of Transportation.

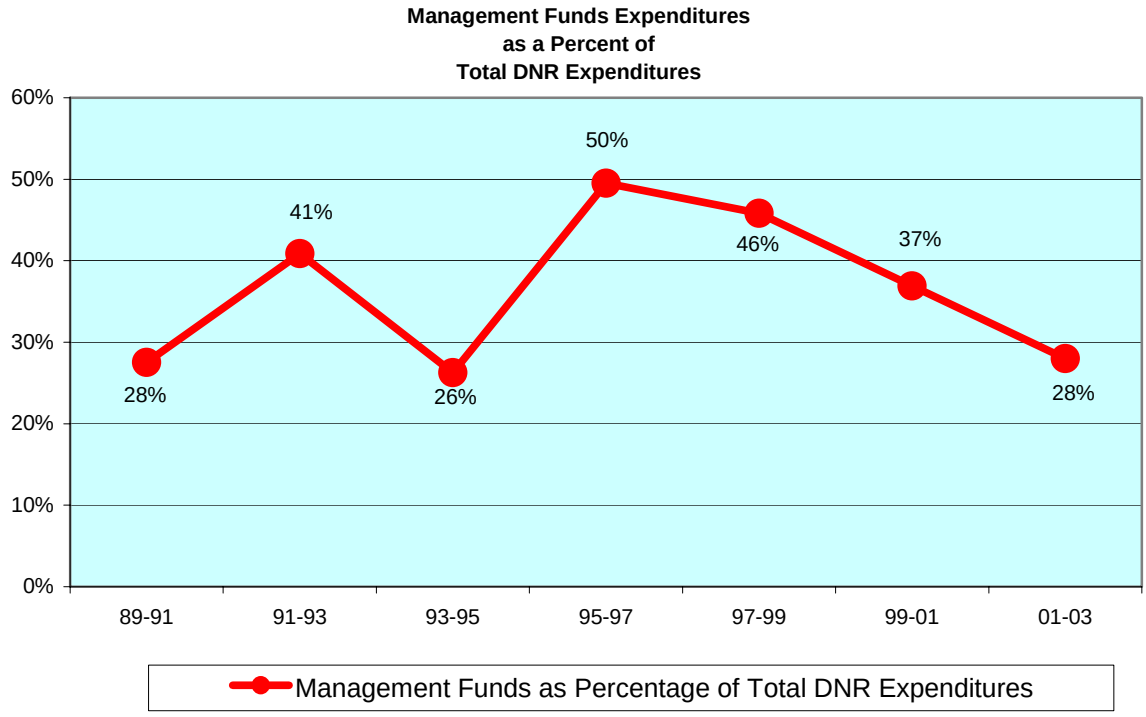
Costs have decreased not increased over the past three years, even though timber sales volume has been increasing over this same period.

9. Please provide a historical comparison of the percent of the total DNR budget supported by revenue generated from the Trust Funds. Is revenue from Trust Funds used to support functions (e.g., Departmental Direction, overhead, etc.) that are not 100% in support of the Trust Fund function? If so, how has that diversion of revenue changed over history?

Comparison of management fund expenditures to total DNR expenditures: The percent of management fund expenditures to total DNR expenditures is not necessarily a meaningful comparison. During the past seven biennia, the State has experienced two recessionary periods where general fund allocation significantly dropped. During these periods, management fund expenditures have remained stable, thereby, increasing the percentage of management fund to total expenditures. Over this period, several of the

DNR programs not funded by management funds such as Forest Practices and Aquatic Resources, have grown. This growth would drive the percentage down. Fire Suppression is also a variable. Fire Suppression cost has significantly increased in the past decade. These are general fund costs that would also change the percentage. Consequently, the relationship between management fund expenditures and total expenditures has little meaning without a great deal of biennium-to-biennium explanation.

Figure 6



Management Fund revenue in other DNR programs: See Briefing Material, Volume 2, page 26.

Eighty-one percent of management funds are charged directly or allocated to trust land management functions. Nearly 19 percent is allocated to agency-wide administrative functions based upon DNR's approved cost methodology. Less than 1 percent is used to manage public access to trust lands.

10. How are direct and indirect costs being allocated for each of the asset classes?
How do RMCA revenues generated for each asset class (e.g. timber, agriculture, aquatic, commercial, etc.) match up to related expenditures (both direct and indirect)?
If costs & revenues are managed in aggregate at the trust level, will changes be considered to better match management costs to RMCA revenues generated on an asset class basis (e.g. cost accounting)? For example, management of timber lands is certainly more time consuming than a commercial building with a long term lease.

Costs are not allocated to asset classes.

The Department of Natural Resources follows the legal mandates of Governmental Accounting Standards Board, Generally Accepted Accounting Principles, Office of Financial Management and State Auditor's Office. This is based on actual costs being charged to the separate funds. Also, individual trusts are charged for direct costs.

Other charges, which cannot be assigned directly to the benefiting fund or trust, are allocated based on a number of allocation methods (actual FTE time, acres, etc.) based on the benefit derived for the activity.

The chart of accounts is structured to match revenues to expenditures based on the Fund and Program Index (activity).

11. Why is the present 25% of revenue inadequate to fund the Department's management expenses?
What are the specific costs being paid with this revenue, and which of those costs have increased (or been incurred) within the last decade to require an increase in the RMCA percentage?
What portion of these increased costs, if any, are associated with environmental mandates (e.g. the HCP and the ESA)?

Please see answers to questions 4 and 19. Also, see Briefing Material, Volume 3, page 9.

Questions about the future and projections

General

12. What are the environmental benefits?
Are the trusts paying for these?
Should the trust be funding benefits that exceed the trust benefits?
How will costs to produce other benefits beyond regulatory requirements be covered?

The principle environmental benefits of trust land management are provided as a direct byproduct of managing the trust lands for sustainable natural resource production. Additionally, trust lands are subject to the requirements of federal and state environmental regulatory laws. Compliance with these laws, thereby avoiding damage to publicly owned environmental resources, is an integral aspect of trust land ownership. These requirements include the department's federally approved Habitat Conservation Plan, which, in the judgment of the department, best controls present and future regulatory risks to the beneficiaries resulting from the state's legal obligations under the federal Endangered Species Act.

Legally required regulatory compliance is a normal land management expense, appropriately born by the trusts, in this case. Alternative ways for the state to cover these land management expenses would be a question for the state legislature. The Department believes it is not incurring costs to produce benefits beyond regulatory requirements or prudent trust land management. See also question 14.

It is beyond the scope of the Independent Review Committee's charter to determine how to fund legitimate expenses of trust land management. However, see the answer to question 22.

13. Would it be better to just "take the money and run?"

Current primary methods to convert trust lands and resources to trust funds are sales of valuable materials like timber and sale of land. In the case of timber sales, common law trustee duties as well as state law require that harvests be sustainable over the long term, and not favor present beneficiaries over future ones. Land sales are substantially limited both by the department's staff capacity and by longstanding legislative policy to maintain the publicly owned land base.

Nevertheless, the Department's sustainable harvest program does consider the substantial current inventory of timber on trust lands, within overall sustainability constraints.

Subject to budgetary considerations the department continues to diversify and reposition assets to increase net return on trust asset values.

14. Will the Committee review the segregation of costs tied to the federal/state legal requirements versus public benefit targets? The trusts need to bear the cost of the federal/state requirements but arguably should be exempt from any non-federal/state requirements that increase costs and decrease revenues.

Information previously provided to the Independent Review Committee demonstrates that the department spends much less than 1 percent of management account funds on expenses related to public use of trust lands. These expenses are for risk avoidance or response to actual problems, such as cleaning up methamphetamine labs and other hazardous wastes, abandoned vehicles, and garbage removal. The department also engages in planning and public involvement at levels that are prudent for a large public landowner, so as to continue the overall trust land management program in the face of community interest. All these expenses enhance the revenue potential of trust lands .

15. What would the cost structure be if the trusts did not have timberlands as the principal holdings?
Will the Committee evaluate whether it is proper under DNR trust responsibilities to keep the trusts so heavily invested in upland forests if the cost structure for doing so is unduly burdensome?

Currently, more than 90 percent of trust land value is in timberland. As stated in the answer to question 13, the department repositions and diversifies trust assets. As part of the asset allocation strategy, the department acquires other revenue-producing land assets, such as irrigated agriculture and commercial properties. These efforts are limited by department budget and staffing. Further, there are the realities of the real estate market and public response to major transactions involving public land. Therefore, it would not be fruitful, nor is it within the Independent Review Committee's scope to plan for wholesale conversion of 2.1 million acres of forestland.

The Committee may consider recommendations related to these issues.

Timber harvest, prices and revenues

16. What volume would need to be harvested to produce the necessary revenue at the 25% rate to meet associated costs and avoid further budget reductions?
How does this required amount of harvesting compare to the sustainable harvest calculation?

This question is essentially the same as one addressed in Briefing Material, Volume 3; please see page 4 of that document.

The Board's rationale for selecting their Plan with the associated harvest level, rather than alternatives with higher average annual harvest volumes, included several considerations:

1. Avoiding large annual or decadal swings in volume which would be disruptive for some beneficiaries;
2. Employing active innovative forestry techniques which will accelerate development of structurally complex forests (an HCP requirement) while increasing trust revenue, thereby providing more management flexibility; and
3. Incorporating aggressive but reasonable expectations about DNR's implementation of higher levels. Under the Board's decision, to employ active management over a larger portion of the landscape, average harvest levels in the second decade will be 574 mmbf/yr, compared to 597 mmbf/yr for the first decade.

Because of the nature of DNR's variable and fixed costs, expenditures exceed management fund revenues at the current volume, price, and current statutory ceiling. DNR's projections show that simply increasing volume alone, to the new level set by the Board, will not reverse this trend. Therefore, at higher volumes, total expenditures continue to exceed total management fund revenues, leading to a rapid depletion of the management funds.

As DNR developed the new Sustainable Forestry EIS and evaluated the costs of the various alternatives, <u>several issues became clear:</u>

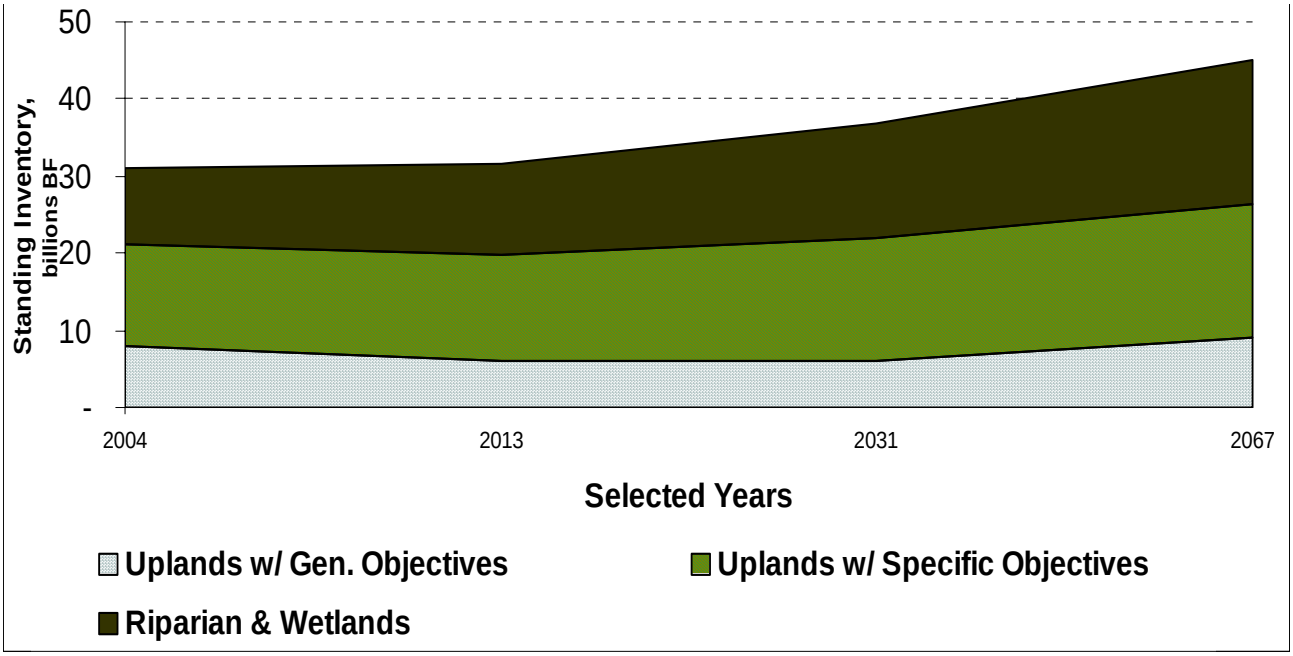
- Even without any changes to current policies or harvest levels, the costs of business were in excess of the revenue at 25 percent.
- Under any of the EIS Alternatives, the fund balances would decline and quickly go negative, something not permissible in state government.
- To prevent a negative fund balance, DNR would need to summarily curtail investments, causing a very large drop in revenue to the beneficiaries, including the State General Fund.
- As revenues collapsed, the ability to generate revenue would be significantly eroded, starting a "death spiral" as shrinking revenues provided less and less revenue for the beneficiaries.

- As an alternative to ever decreasing revenue, we found that significant increases in net revenue to the beneficiaries could be obtained from investment levels equivalent to a management percentage of about 30 percent of gross revenue.
- However, we also found that by investing at a cost-equivalent of 30 percent of gross revenue, the beneficiaries would actually receive more revenue, even with a 5 percent increase in the management deductions. The ability to make those investments today is a critical component of sustainable harvest implementation.

17. Will the timber inventory be increasing during the sustainable harvest period?

Yes. This is discussed in some length in Briefing Material, Volume 2, Section 2.1.1, starting on page 16. The following graph is reproduced from that section.

Figure 7 **Standing Inventory by Land Class, Preferred Alternative**



The current western Washington inventory is 31 billion board feet. It will increase 45 percent by 2067 to 45 billion board feet. Essentially, all the increase in volume comes in the land classes (e.g., riparian and wetland) necessary to meet the requirements of the Federal Endangered Species Act and the State Forest Practices Act. The volume in the uplands with general management objectives stays fairly constant.

18. What are the market expectations and DNR projections for real timber price increases over the next couple decades? How have these real price increases, if any and the timber age-class schedule been factored into the harvesting plans and projected management deficits?

The Projected nominal and real (adjusted for inflation to FY2003 purchasing power) prices are shown in the answer to question 7 above. For information on the reasoning behind those projections see Briefing Material, Volume 3, page 5, "Is DNR's Timber Price Forecast Reasonable?"

Sustainable harvest planning is primarily driven by economic and biological factors. As indicated in question 7 the assumption used in the sustainable harvest projections was no real price increase or decrease over the projection period.

The department matches timber sales to predicted markets to maximize expected returns. For example, stands that have a higher percentage of hardwoods would be identified for sale when hardwood prices are relatively high. Once sales are identified, they are marketed to take advantage of seasonal variations in species prices.

Management costs and funds

19. What is the increased expense needed to produce increased revenue?
What is the plan for how the additional management funding would be spent?
Are there specific targeted expenses that will be covered by this increase?

Briefing Material, Volume 3, directly answers the question in some detail (please see page 13). In summary, DNR anticipates the need for some 95 additional employees over the next four years. Based upon the initial estimates approximately 85 percent would be hired for direct timber sales operations. Most positions are field-level professionals necessary to make the complex decisions to capture the potential of the trust lands. The remaining 15 percent would be hired for related agency administrative activities. There are some fixed start-up costs for vehicles and other equipment.

See also answer to questions 20 and 25.

20. What is the additional increment of work that causes the costs to go up?
What is the cost driver?

There are two primary cost drivers:

1. The cost of additional staff to meet the sales volume expectations, and
2. Increased salary and benefit costs and other inflationary pressures.

The planned increase in the number/volume of timber sales is the primary cost driver. The implementation plan calls for a sales volume increase in western Washington, incrementally rising from 453 mmbf in FY2005 to 636 mmbf in FY2011 and continuing at that level through FY2016.

In addition to the increased sales volume, a half-million acres in western Washington will be more actively managed to deliver important economic and ecological benefits.

The Department has initially determined that 95 additional FTE will need to be added incrementally during the first four years of implementation. Staffing will continue at this increased level for the remainder of the first decade. The phasing-in of the additional staff will allow the Department to more accurately gauge the level of actual staffing required. Eighty-five percent of the new staff will be assigned to the direct operating programs. Additional staffing for Financial Management, Human Resources, Information Technology and Attorney General will be added in the third and fourth year. This administrative staff represents 15 percent of the total new staffing.

The State has just finished negotiating a new collective bargaining agreement. The agreement will increase employees' salaries by 3.2 percent in the first year and 1.6 percent in second. Health benefit and pension costs have also increased. Changes in salary and health benefit costs will increase Management Fund expenditures by $5.4 million at current staffing levels in the next biennium. Our projections have increased these and other costs by a standard inflationary rate (3%) for the remainder of the decade.

See the Briefing Material, Volume 3, page 14.

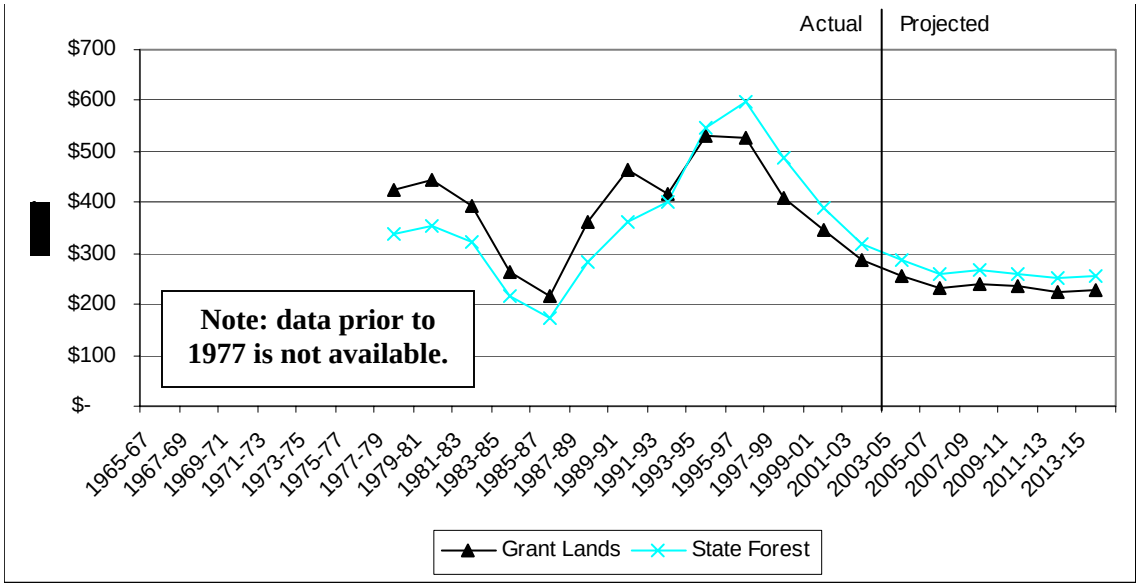
21. What change has occurred that has resulted in the need for this "rate" increase? Please be specific.

There are two primary factors. The first is the decline in real timber prices. Some 85 percent of land management revenue comes from timber sales. The decline in timber sales values shown in Figure 8 has been substantial and shows no sign of recovery in the next decade.

The second major factor is the cost of business has increased since 1971, the date the Legislature last adjusted the funding of trust land management. In the following three plus decades, a number of changes have occurred that affect the cost of doing business in Washington State. Other changes were made as public policy relating to trust lands and forest management evolved in Washington. Briefing Material, Volume 1, Section 3.4 outlines a number of legal, social and policy changes that have materially increased costs.

Despite these increased costs, the department's management fund expenditures, when adjusted for inflation, are the lowest they have been since 1974.

Figure 8 Removal Value ($/mbf) Federal Granted and State Forest in 2003 $'s



22. What alternatives to this rate increase were reviewed and why were they rejected?
If this rate increase is not forthcoming, what alternative actions are proposed that will have the least impact on the Trusts, and what is that impact?
Are there other sources of revenues that can be examined to meet the needs for managing the timber trusts?

The alternative to increasing management account revenue would be to substantially reduce activities not directly linked to trust revenue. Because major cuts in these areas have already been implemented, further cuts will inevitably have consequences for trust beneficiary revenue. These consequences include such things as an inadequate information base upon which to base timber sales, procedural failures in the timber sales program, risk of being out of legal compliance with federal and state laws, risk of active public opposition to revenue-generating activities, etc. To the extent that these consequences reduced timber sales levels, revenue to both beneficiaries and the management accounts would be reduced, triggering repeated cycles of revenue reductions.

One alternative is a statutory change that modifies, in some way, the percent ceiling set in 1971. The department has not specifically proposed a statutory change. Other ways of increasing management funds might include issuing bonds, receiving loans, or receiving direct legislative appropriations of non-trust funds. Although these alternatives each have advantages and disadvantages, none have been ruled out.

23. Please share the portions of the "thorough technical and economic analyses" that show environmental benefits and sustainable forest management cannot be obtained without an increase in rates. On what will the money be spent?

The *Final EIS on Alternatives for Sustainable Forest Management of State Trust Lands in Washington July 2004* contains substantial information that helps understand and quantify the gains due to the Board's Plan for Sustainable Forest Management; the document may be found at www.dnr.wa.gov.sepa. The Board directed DNR in Resolution 1110, Section 5 to identify "implementation timelines and the cash flow necessary" to implement the Plan
(See http://www.dnr.wa.gov/htdocs/fr/sales/sustainharvest/030204resolution1110.pdf).

Subsequent to Resolution 1110 in March 2004, the DNR presented cash flow analyses and fund balance projections to the Board, including summaries of both gross and net revenues for each Alternative. For a summary of volume and revenue modeled for the planning decade, see
www.dnr.wa.gov/htdocs/fr/sales/sustainharvest/597_636fin_sum8_3104.pdf

Some of this information has been updated and is contained within the Independent Review Committee Briefing Materials.

In particular, please see the answers to questions 4 and 19 of this document.

**24. The focus of this Committee appears to be primarily on trust land management and RMCA. Yet, there are other DNR-Administered Funds that presumably share in the overhead to support DNR operations. Are those funds being reviewed as well?
If an increase to RMCA percentage is recommended, will the other DNR-Administered Funds have corresponding increases in overhead to support DNR administration and agency functions?**

DNR allocates administrative costs across 22 funds based upon a cost allocation methodology reviewed annually by the Office of the State Auditor. Administrative costs are allocated based upon actual FTE's charged to each fund. The allocation of administrative costs is adjusted monthly based upon the actual staff month expenditures charged to each of the program's 22 funds.

The fund balance in a number of DNR funds has caused the Department to review several program expenditures during the past four years. Faced with declining fund balances and general fund reductions, DNR has intensively reviewed all programs including the administrative programs. As a result, DNR has reduced administrative FTE from 171 to 146 since FY2001. Any reduction in administrative costs benefits all
22 funds

25. What elements of the management of the trust lands can be effectively outsourced at a cost savings?

Under new civil service reform laws, agencies may outsource certain functions when not displacing or reassigning current employees, or where contracting for that function has been ongoing since 1977. In other cases, outsourcing can occur, although existing employees are given certain rights to compete for contracts. The department is assessing opportunities for contacting that may be associated with implementing the Board's direction on harvest levels, considering feasibility, legal requirements, and potential net savings.

Beneficiary revenues

26. What is the incremental benefit that the trust beneficiaries will in fact derive from the increased management cost?
When and how will that benefit be realized?
Is the increased benefit adequate to justify the increased cost?
Will the benefit be realized in the form of increased revenues to the Universities?
For any recommended changes, please prepare an economic analysis detailing the impact of a proposed RMCA fee adjustment on the trust beneficiaries.

Briefing Material, Volume 3 answers this question and has an extensive analysis of this issue starting on page 15. The change in real revenues to the beneficiaries going from the current harvest and a 25 percent deduction to the board-approved harvest with a 30 percent deduction is shown in figure 6.4 (Volume 3).

The analyses show that even if the percentage is raised to 30 percent, the beneficiaries would still receive more net revenue.

This is due to the interaction of several factors.

- Production expenditures occur two plus years in advance of the actual revenue due to the time to engineer a timber sales, sell a sale and actually log a sale. These facts, by themselves, would seemingly be impossible to overcome without some other changes.
- Revenue to the beneficiaries was accelerated by reducing the timber sales contract duration. This produces a near-term surge in cash that offsets a potential change in percentage.
- Those trusts with revenue that largely comes from permanent funds have few or no perceptible changes to revenue to the beneficiaries; see Briefing Material, Volume 2, Section 1, for a more complete discussion of revenue flows to the beneficiaries.
- Compared to today's harvest levels, sold volume will increase.

Appendix – original questions from beneficiaries

A. Questions raised by Trust Beneficiaries in meetings regarding the Independent Review Committee

Washington State School Directors Association (WSSDA)

- How do other state land offices manage trust lands for their beneficiaries without a management fee?

Higher Ed — University of Washington; Washington State University; The Evergreen State College; Eastern, Western, and Central Washington universities; and the Council of Presidents

- What is the volume that would need to be harvested to avoid further budget reductions?
- What are the environmental benefits? Are the trusts paying for these? Should the trust be funding benefits that exceed the trust benefits?
- Comment: we're bothered by an increase above the 25% management fee.
- How does the 25% rate compare with how forest-lands are managed elsewhere around the country?
- Will the timber inventory be increasing during the sustainable harvest period?
- What is the plan for how the additional management funding would be spent?
- What does status quo look like?
- What is the increased expense needed to produce increased revenue?
- How will costs to produce other benefits beyond regulatory requirements be covered?
- Community college trust—What new lands have been purchased? How was the money spent? Where did it go? What happened to the management fund?
- Would it be better to just "take the money and run?"

Capitol Building Trust

- What is the additional increment of work that causes the costs to go up? What is the cost driver?

B. Questions submitted by the University of Washington

1. The focus of this Committee appears to be primarily on trust land management and RMCA. Yet, there are other DNR-Administered Funds that presumably share in the overhead to support DNR operations. Are those funds being reviewed as well? If an increase to RMCA % is recommended, will the other DNR-Administered Funds have corresponding increases in overhead to support DNR administration and agency functions?

2. Will the Committee review the segregation of costs tied to the federal/state legal requirements versus public benefit targets? The trusts need to bear the cost of the federal/state requirements but arguably should be exempt from any non-federal/state requirements that increase costs and decrease revenues.

3. How are direct and indirect costs being allocated for each of the asset classes? How do RMCA revenues generated for each asset class (e.g. timber, agriculture, aquatic, commercial etc.) match up to related expenditures (both direct and indirect)? If costs & revenues are managed in aggregate at the trust level, will changes be considered to better match management costs to RMCA revenues generated on an asset class basis (e.g. cost accounting)? For example, management of timber lands is certainly more time consuming than a commercial building with a long term lease. Please note we are not suggesting for a specific review of non-upland trust revenues and expenditures, only a comparison.

4. Will the private sector be surveyed to obtain management cost data and, where applicable, compare to DNR management costs (by asset class per #3 above) to ascertain opportunities for further management efficiencies and savings?

5. Inventory of standing timber is expected to increase by 45% over the next 64 years up to 45 billion bf. What would be the required increase in timber harvested to produce the necessary RMCA revenue at the 25% rate to meet associated costs? How does this required amount of harvesting compare to the sustainable harvest calculation?

6. What are the market expectations and DNR projections for real timber price increases over the next couple decades? How have these real price increases, if any, and the timber age-class schedule been factored into the harvesting plans?

7. How do the current land treatments compare to the most economically efficient land treatments? If there is a difference, what is the impact on revenue, related RMCA revenue and associated management costs? Please share with the Committee and the beneficiaries the economic analyses performed that indicate

8. how the trusts were impacted (either positively or negatively) by the recent sustainable harvest calculation.

9. Are there other sources of revenues that can be examined to meet the needs for managing the timber trusts?

10. Finally, for any recommended changes, please prepare an economic analysis detailing the impact of a proposed RMCA fee adjustment on the trust beneficiaries.

C. Questions submitted by Washington State University

1. Why is the present 25% of revenue inadequate to fund the Department's management expenses? What are the specific costs being paid with this revenue, and which of those costs have increased (or been incurred) within the last decade to require an increase in the RMCA percentage? What portion of these increased costs, if any, are associated with environmental mandates (e.g the HCP and the ESA)?

2. How will the increased management expense be used? Are there specific targeted expenses that will be covered by this increase?

3. What is the incremental benefit that the trust beneficiaries will in fact derive from the increased management cost? When and how will that benefit be realized? Is the increased benefit adequate to justify the increased cost? Will the benefit be realized in the form of increased revenues to the Universities?

4. In evaluating the propriety and effect of the proposed management fee increase, are other Department administered funds also being reviewed? If an increase to the RMCA percentage is recommended, will the other Department administered funds have corresponding increases in overhead to support Department administration and agency functions?

5. Will the Independent Review Committee review the segregation of costs tied to the federal and state legal requirements versus "public benefit" targets?

6. How are direct and indirect costs being allocated for each of the asset classes? How do revenues generated for each asset class (e.g. timber, agriculture, aquatic, commercial) match up to related expenditures (both direct and indirect)?

7. What would the cost structure be if the trusts did not have timber lands as the principal holdings? Will the Committee evaluate whether it is proper under the Department's trust responsibilities to keep the trusts so heavily invested in upland forest lands if the cost structure for doing so is unduly burdensome?

8. If costs and revenues are aggregated at the trust level, will changes be considered to better match management costs to revenues generated on an asset class basis? For example, management of timber lands is certainly more time consuming than a commercial building with a long term lease. Please note that we are not suggesting that a specific review of non-upland trust revenues and expenditures be made, but we do want a comparison of the costs by asset class to be considered.

9. Will the private sector be surveyed to obtain management cost data and, where applicable, compare those figures to the Department's management costs (by asset class) to ascertain opportunities for further management efficiencies and savings?

10. How does 25% of revenue compare to the fee that would be charged by outside land managers, and how does the Department's cost structure compare to that of outside land managers?

11. Inventory of standing timber is expected to increase by 45% over the next 64 years up to 45 billion board feet. What would be the required increase in timber harvest to produce the necessary revenue to meet associated costs at the current 25% rate? How does this required harvest figure compare to the sustainable harvest calculation?

12. What are the market expectations and Department projections for real timber price increases over the next twenty years? How have these price increases, if any, and the timber age-class schedule been factored into the harvesting plans and projected management deficits?

13. How do the current land treatments and "on the ground" management practices compare to the most economically efficient land treatments? Are similar treatments and practices used by outside land managers? If there is a difference, what is the impact on revenue, related RMCA revenue and associated management costs? Please share with the Independent Review Committee and the other beneficiaries the economic analyses performed that indicate how the trusts were impacted (either positively or negatively) by the recent sustainable harvest calculation.

14. What other sources of revenue have been examined to meet the needs for managing the timber trusts?

15. What elements of the management of the trust lands can be effectively outsourced at a cost savings?

16. Finally, for any recommended changes, please prepare an economic analysis detailing the impact of a proposed fee adjustment on the trust beneficiaries.

D. Additional questions submitted to the committee

1. What change has occurred that has resulted in the need for this "rate" increase? Please be specific.

2. What has the gross trust revenue amount been each year since 1971 adjusted to current dollars using a common state inflation adjuster? What have been the expenses in a similar fashion? What is the percent of expenditures by general object of expenditure historically (e.g., salaries & benefits, contractual services, etc.). This object of expenditure information will provide a glimpse regarding how the allocation of resources might have changed over time. What are the total FTE supporting the Trust over time and what is the average salary (not adjusted for inflation) of that FTE.

3. The summary notes "timber prices have remained low in recent years and are projected to continue at lower than historical levels." Please provide a history and projection of those "timber prices" (actual and adjusted for inflation) historically and on a pro forma basis. We will want to compare the pro forma forecast of timber prices against our forecasted revenue as shown on the Excel spreadsheet entitled Revenue by Fund V14 w_o TLT.xls 8/17/2004.

4. What are the efficiency measures initiated over the last three years and how much real savings did they generate? What have been the contributors to increased costs over the past three years and how did those contributors help with the effectiveness of the management of the Trust?

5. Please provide a historical comparison of the percent of the total DNR budget supported by revenue generated from the Trust Funds. Is revenue from Trust Funds used to support functions (e.g., Departmental Direction, overhead, etc.) that are not 100% in support of the Trust Fund function? If so, how has that diversion of revenue changed over history?

6. What alternatives to this rate increase were reviewed and why were they rejected? If this rate increase is not forthcoming what alternative actions are proposed that will have the least impact on the Trusts and what is that impact?

7. Please share the portions of the "thorough technical and economic analyses" that shows environmental benefits and sustainable forest management cannot be obtained without an increase in rates. On what will the money be spent?